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ABSTRACT

This paper describes Illinois' program for warning school districts of impending financial troubles and the reactions of superintendents to the state's "early warning" program. In February 1992, the State of Illinois issued a list of 111 school districts, out of a total of 946 districts, that were on the Financial Watch list. Of questionnaires sent to the superintendents of the 111 districts, 84 usable responses were received, a 77 percent response rate. Findings indicate that over 27 percent of the districts had an operating fund balances-to-revenues ratio worse than negative 3 percent, and one-half of the superintendents unrealistically believed their financial problems to be no worse than those of other districts. Most districts had been on the list for several years. Superintendents attributed insufficient state aid as the main cause of their financial troubles, and two-thirds reported that the state had not been helpful. It is recommended that the state continue its early warning program; however, the state should: (1) provide early, practical support; (2) become involved progressively; (3) inform superintendents of their districts's situation relative to other districts; (4) allow advance borrowing as a short-term solution only; (5) make known that placement on the list is not an indication of poor financial management; and (6) increase the percentage of state aid to the schools. Three tables are included. (LMI)

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An Early Warning System for Schools:
An Examination of Illinois' Financial Watch List

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INTRODUCTION

Many school districts across the country are having difficulty obtaining the revenues they need to support their expenses. As a result, many districts proceed down the rough road from a budget surplus to a barely balanced budget to a deficit budget, eventually borrowing next year's revenue to pay for this year's bills.

While some districts recognize the signs leading to this road and take steps to correct the situation before it becomes too extreme, other districts do not see the trouble coming, ignore the warning signs, or choose to accept the consequences of financing a deficit. Because of these districts, some states have established formal means to identify these districts, notify them of their pending problems, and give them some help. This article examines what one state, Illinois, has done to warn districts, and tells how the superintendents of those districts have reacted to the state's "early warning" program.

BACKGROUND

In 1985, the State of Illinois decided to formally notify those districts that were having financial problems or were heading in that direction. The criteria used to select the districts were as follows: Based on the prior year's Annual Financial Report, all districts whose Operating Fund Balances to Revenues Ratio was -10% or worse were included.¹ This Operating Fund Balance includes the Educational Fund, Operations and Maintenance Fund, Transportation Fund, and the Working Cash Fund (a fund which can be levied and used to provide loans to any other funds that are levied by the district.) Thus, this Ratio divides the sum of the balances in these four funds by the sum of the annual revenues of these funds, based on a cash accounting basis. (Districts which operate on a modified accrual basis are converted to a cash basis for this Ratio.) Districts that met this criteria were sent a letter to let them know that they were in financial danger and were offered help by state officials.

The criteria changed in 1988 to that which is in place today: Using the prior year's financial reports, all districts whose Operating Fund Balances to Revenues Ratio was +5% or worse (including all negative Ratios) are notified by the state and are said to be placed on the state's

"Financial Watch List." Roland Burris, Comptroller of the State of Illinois in 1990, said that since school districts are required to submit detailed financial information to the state, the state should be able to judge the financial condition of the districts. And, "when fiscal troubles arise, the State Board calls attention to the problem and offers assistance as needed in order to avoid more serious fiscal problems."²

Section 1A-8 of the Illinois School Code lists eight criteria for a school to be "in financial difficulty." Although the concept of the Operating Fund Balances to Revenues Ratio is not listed in the School Code to determine financial difficulty, the State Board felt that there was a relationship between this Ratio and three of the criteria listed in the Code:

(1) The district has for two consecutive years adopted a budget in which budgeted expenditures exceed budgeted revenues and reserves.

(2) The district has issued tax anticipation warrants in anticipation of a second year's taxes when warrants in anticipation of current year taxes are still outstanding.

(3) The district has issued teachers' orders for wages.³

(A district may be removed from the Financial Watch List by achieving a Ratio greater than 5%. Also, districts who have been on the

List for two years but have a Ratio above zero will be removed from the List.)

The State Department of Education follows a "progressive attitude in its financial monitoring efforts."⁴ First, it encourages districts to take voluntary actions to avoid financial difficulties. If that fails, the districts are placed on the Financial Watch List (after meeting the criteria) as mentioned previously. This early warning notice is given to districts so that they can address their problems. Districts which continue to be on the List for second year and have a moderate negative Ratio are considered to be on *continued watch*. Those districts have to submit a written report on their financial condition and detail the actions taken to improve the condition. Districts which have two consecutive years of negative Ratios and a current Ratio of -10% or worse receive a *financial status review*. This review includes a meeting between school personnel and the staff of the State Board. This meeting will determine if the district meets the criteria (as stated in the School Code) for certification as a district "in financial difficulty" and whether the district has taken steps to avoid such a designation. If the district meets the criteria and has not taken sufficient steps to avoid it, the district may be recommended to the State Superintendent and then to the State

Board for certification as being "in financial difficulty."⁵

An examination of the Financial Watch Lists from FY 88 to FY 92 in Table 1 shows that the number of districts on the List has remained about constant for the last three years, with the percentage of districts taken off the List declining over these years.

Table 1 goes about here

Since the placement on the Financial Watch List signals an early warning sign to districts that they are in danger of being certified as "in financial difficulty" by the State Board, a study was undertaken to examine the perceptions of the superintendents of those schools on the Financial Watch List.

METHODOLOGY

In February, 1992, the State of Illinois issued a list of 111 school districts out of 946 that were on the Financial Watch List. In March, a questionnaire was sent by the researchers to the superintendents of all of

the 111 Watch List districts. Districts that did not respond were contacted by phone. The replies revealed the following: two districts had consolidated and "no longer existed;" 93 districts returned questionnaires with 84 (of the 109 remaining districts) of the questionnaires being usable. This produced a 77% response rate. The data were subjected to a frequency analysis and a Pearson correlation analysis.

RESULTS

DATA ON THE DISTRICTS

The districts that responded reported that they had been on the Financial Watch List from one to five years, as follows:

Table 2 goes about here

The superintendents whose districts were on the List for more than one year were asked to describe the change, if any, in the financial

condition of the district since being placed on the List. Over 60% stated that the condition had improved, 21.2% said it was worse, and 18.4% said it was about the same.

As stated earlier, to be placed on the List, the Ratio of the Operating Fund Balances to the Revenues has to be 5% or less, including negative Ratios. To get some idea of the financial condition of the districts, the superintendents were asked to pick one of four ranges of percentages pertaining to this definition. Table 3 gives the results of this question.

Table 3 goes about here

THE DEFINITION OF THE FINANCIAL WATCH LIST

Since the definition of the List itself might be controversial, the superintendents were asked whether they felt that the definition was appropriate. Nearly equally divided, 39 % said that it was appropriate while 40.2% disagreed with the definition. The remaining superintendents stated that they had no opinion or were not sure whether the definition was appropriate.

Those who felt that the definition should be something different were asked to tell how it should be changed. A few superintendents felt that whether the budget was balanced or not should determine placement on the List, while others felt that if a district could pay all of its bills on time, it should not be on the List.

The superintendents were asked whether they really felt that their districts had severe financial problems. In other words, should they be on a Financial Watch List? The largest percentage, 43.7%, felt that they did have financial problems, but that their problems were about the same as everyone else and that they should not be on the List. On the other hand, almost as many, 41.2%, agreed that they had financial problems and should be on the List. Only 15% felt that they did not have severe problems (and should not be on any List).

SOURCES OF FINANCIAL DIFFICULTY

What caused the financial difficulty for these school districts? Sometimes school districts are thought to have financial problems because of local economic conditions imposed upon them. For example, some municipalities establish incentive programs to attract businesses by abating some or all of the property taxes that the new businesses

would produce. A similar incentive is used in Illinois to bring in businesses into Enterprise Zones to improve blighted areas. In addition, Illinois has a Tax Increment Financing plan to encourage businesses to locate within an area by using the increased property taxes, for a certain period of time, to finance parking lots, sidewalks, lighting, and other improvements in the area being developed, instead of having the taxes go to schools and municipalities. When asked whether these factors contributed to the financial problems, over 82% of the superintendents in this study stated that these were not factors in the district's financial difficulties. When asked if there had been a major change in the industrial/business sector of the district in the past ten years, like the closing of a large shopping center or a coal mine, or the opening of a large shopping center in a nearby district, over 76% said this also was not a factor.

For those 23.5% who felt that there was a major change in the community, the three most frequently listed changes were as follows:

The assessed value of farmland had decreased.

Coal mines had closed.

Businesses had closed.

If the incentive programs were not factors in the districts' financial problems, what *did* cause the problems? According to the superintendents, the number one factor named was insufficient state financial support, as this factor was named by over 90% of those responding. (Illinois' state support of its schools has declined from a high of 48.4% of the local schools' total revenue in 1975-76 to its current 33.6%.) The superintendents stated that static or declining local property values accounted for the second highest factor which caused a problem for the districts. Although the media plays up the election results of efforts to raise local property taxes through referenda, the majority of the superintendents did not list the unwillingness of the local citizens to support local tax increases as one of their primary problems. Only 41.7% of the respondents listed this factor as a problem.

As noted above, the second factor considered to be a problem involved the local property tax. When superintendents were asked to identify the major problem in preventing their districts from acquiring the necessary local funds, they responded (58.2%) that their local tax base was too small. They did not perceive the assessment practices to be uneven or unfair, nor did they feel that the local tax levy was too low or that there were too many tax exemptions.

EFFECTS OF BEING ON THE FINANCIAL WATCH LIST

What were the effects of being placed on the Financial Watch List? Did the districts make changes? What about the public's reaction? The superintendents were asked what changes they had made as a result of being placed on the Financial Watch List. Over 63% stated that they had *not* changed their budgeting methods, but 61.4% had instituted new cost control measures because of the listing. Those districts using new cost control measures tended to be districts with decreasing enrollments.

One of the assumptions of the concept of the List is that those districts so listed would receive assistance or advice from the state. When asked whether this state help had been received, 68.3% of the responding superintendents stated that the state had not been helpful to the district.

Another assumption was that being placed on this List would help the district alert the community, parents, and media to the importance of addressing the financial problems of the district. When asked about this, just over half of the superintendents (51.2%) stated that the alert was not necessary because the community already knew about the problem. On the other hand, 48.8% felt that it had alerted their

communities and the media to their financial problems. Similarly, 52.6% stated that it did not alert their teachers since they knew about it already. The remainder, 47.4%, said that the listing did cause their teachers to believe that the districts really did have financial difficulties. And, those districts whose listing caused the teachers to believe that there were financial difficulties tended to be districts in the study that had the worst conditions.

EFFORTS TO CONTROL FINANCES

What had the districts done to prevent these problems? The superintendents were asked what actions had been taken or strategies used to improve the financial condition of the districts *prior* to placement on the List. The actions taken prior to placement on the List, in order of mention, are the following: (The superintendents could name more than one action.)

Tax anticipation warrants (mentioned by 63 of 84 superintendents)

Reduction of non-certificated staff (36)

Reduction of certificated staff through attrition (also 36)

Reduction of programs (35)

Reduction (RiF) of certificated staff, not through attrition (28)

Reduction of administrative staff (23)

Closing of buildings (14)

OPINIONS ON THE WATCH LIST

Finally, the superintendents were asked to name some positive aspects of being placed on the List, and some negative aspects. Although not all responded, the items below are some of the responses received:

Positive aspects:

It focused attention on the problem.

It helped the district pass a tax levy.

It made the board and the administration take a hard look at their spending.

It made all employees of the district aware that they had to be responsible.

It pulled people together to support actions taken.

It helped the board with teacher negotiations.

Negative aspects:

It caused the community to think there is poor management.

It was negative publicity for the district.

It caused the public to lose confidence in the administration.

It hurt in hiring teachers; in getting people to move into the community.

It increased administrative workloads for the necessary reports.

It caused negative comparisons with nearby communities.

It caused some banks to refuse to loan the district money.

One superintendent stated the following: "We passed a tax referendum in 1989. We have been a high growth district with a low assessed valuation. We depend on state aid, and the state is not coming through. Then, they place us on the Watch List."

DISCUSSION AND CONCLUSIONS

The data received in the study show that there are, indeed, districts in financial difficulty. Over 27% of the districts reported a Ratio worse than negative 3%, and this was the second highest range of Ratios reported (see Table 2). Also, about half of those who felt they had financial problems said that their problems were similar to those in other districts, demonstrating that a substantial number of superintendents may not have a realistic view. Since under 12% (111 of 946) of the

Illinois districts were placed on the Financial Watch List, it is simply not true that most districts have the same degree of financial difficulty.

Because there are districts with substantial financial problems, and since some of the superintendents do not realize that their problems are worse than other districts, the concept of a Financial Watch List to warn districts is a good idea.

The superintendents were about equally divided on whether the criteria for the Watch List were appropriate. The superintendents who suggested other criteria for inclusion on the Watch List felt that not having a balanced budget or not paying their bills on time might be better criteria. These definitions are simpler, to be sure, but may not take further borrowing into account. A district, under this criteria, could borrow to pay bills on time, increasing the district's debt and spending money for interest, but not improving the overall financial health of the district. The current definition is better than the alternatives suggested by the superintendents.

In further discussing the Watch List, the superintendents felt that its prime attribute was that it focused attention on their districts' financial problems. Yet, over half said that the community already knew about the problem. So, the best feature of the List, according to the

superintendents, applied only to a minority of districts. The negative aspect of the List mentioned most was that it caused the community to think that there was poor management in the district. Although some state publications state that placement on the List does not mean poor financial management, the superintendents' responses show that many community members feel that placement on the List suggests that the school administration has not been effective in directing the financial matters of the district.

The superintendents stated that the major action they had taken to help their districts improve financially was to borrow money against future tax revenue. In fact, three-quarters (63 Of 84) of them had done this. As stated earlier, while this helps with cash flow (and is used by districts in good financial conditions for the same reason), it does not solve the problem. The money borrowed always has to be repaid with interest. It is also enlightening that those districts that did use some cost control methods tended to be districts with decreasing enrollment--those that would lose state aid as enrollments went down, at the same time that the overall level of state assistance for all districts is decreasing.

One discouraging feature revealed by the data was that most of the

districts had been on the List for several years. The highest percentage of districts was for those on the List for their fourth year (see Table 1). So, being on the List for a year or two does not mean that the district will be able to work out its problems and get removed from the list. The percentage increased each year from one to four years (on the List). Perhaps if the List had had the present criteria prior to 1985, the fifth year would have been an even larger percentage.

The encouraging part of this multi-year inclusion on the List is that over 60 % of those on the List for more than one year said that their districts' financial conditions had improved. Yet, while it may have improved (or the superintendents felt that it may have improved), it did not improve enough for the district to be removed from the List. Finally, over 21% said that the conditions of their districts became even worse.

It was somewhat surprising that the business/industrial base in the district did not seem to be a problem. The superintendents did not think that their problems were caused by businesses moving away or by tax abatement incentives that limited the taxes they might receive. The number one problem was clearly insufficient state aid. Over 90% of the reporting superintendents mentioned this as the main cause of their financial problems. Illinois' current state contribution of 33.6 % of the

average district's revenue is not enough for the schools, according to the superintendents. Illinois ranks 50th among the fifty states plus the District of Columbia according to the relation of expenditures to \$ 1,000 of personal income.⁶ This indicates that the state has the wealth to support schools more fully but chooses not to do so.

The second factor mentioned by the superintendents as a problem was declining local property values. Yet, the respondents did not have a problem with assessment practices or tax exemptions or tax abatement incentives. Thus, there is not much that can be done about this second factor.

Finally, in spite of this early warning system that involves state help and advice to those districts that are in financial difficulty, over two-thirds of the superintendents said that the state had not been helpful to their districts and had not given them assistance and advice since being placed on the List.

Some conclusions from this study and suggestions for other states are as follows:

1. Having an early warning system is a good idea. Other states which do not have such a system should consider implementing one.
2. The involvement of the state should be progressive. As the financial

condition of the districts becomes worse, the state should become more involved.

3. The state needs to provide real help to the districts: personal advice, workshops, required meetings with state and local officials, examples of what other districts have done to correct their problems.

4. Help from the state needs to be on a progressive basis but should not be delayed until a district is already in severe financial trouble. It should come earlier when, hopefully, corrective action can be taken in time to prevent further problems.

5. Superintendents need to be informed by the state that most districts are not in financial trouble, at least as defined by a standard such as the Watch List. Those on the List need to understand that only a small minority of districts are on the List, and these districts must face up to their problems and to the solutions that can correct the problems.

6. Superintendents also need to understand that borrowing is a short-term solution to a cash flow problem but not a long-term solution for the district's financial problems.

7. The state needs to emphasize in its literature and announcements that placement on an early warning list like the Financial Watch List does not mean that the administration has demonstrated poor financial

management.

8. Finally, states (like Illinois) which contribute a relatively small percentage of a school's revenue need to consider increasing that percentage.

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3. State of Illinois, The School Code of Illinois, 1992 (St. Paul, Minn.: West Publishing Co., 1992), 4.
4. Illinois State Board of Education, 122.
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TABLE 1
FINANCIAL WATCH LISTS
FY 88 TO FY 92

Fiscal Year	No. on List	New to List	Certified	No. Off List
FY 88	182	182	---	---
FY 89	181	63	14	68
FY 90	113	24	15	91
FY 91	116	47	14	45
FY 92	111	37	12	42

TABLE 2
PERCENTAGE OF DISTRICTS
ON WATCH LIST FROM
ONE TO FIVE YEARS

Years on Watch List	Percentage of Districts
1 Year	13.1 %
2 Years	22.6 %
3 Years	28.6 %
4 Years	31.0 %
5 Years	4.8 %
Total	100.1 %

Note: Rounding off makes the total more than 100.0 %.

TABLE 3
PERCENTAGE OF DISTRICTS
HAVING DIFFERENT RATIO RANGES

Ratio Range	Percentage of Districts
5 % to 3 %	41.6 %
2.9 % to zero	20.8 %
zero to negative 3 %	10.4 %
worse than negative 3 %	27.3 %
Total	100.1 %

Note: Rounding off makes the total more than 100.0 %.